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CRIMINAL INSIDER TRADING CONVICTIONS OVERTURNED IN FAR-REACHING RULING

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In a stunning reversal that threatens Southern District of New York U.S. Attorney Preet Bharara's signature achievement, the Second Circuit recently reversed the insider-trading convictions of former hedge fund managers Todd Newman and Anthony Chiasson. Over the last seven years, Bharara's office has secured more than 80 convictions for insider trading. Many of those may now be imperiled by the appellate court's decision, which appears to substantially raise the bar for what most be proved in an insider trading case. Newman and Chiasson were "remote tippees," individuals who allegedly received material inside information indirectly, and often several steps removed, from corporate insiders. Remote tippees were part of Mr. Bharara's effort to aggressively push the envelope with respect to who might be liable for insider trading. With the Second Circuit's recent decision, the court may have created, or at least underscored, the line in the sand for culpability for insider trading. Prior blog posts by colleagues Jeanine Kerridge and Jacob Zipfel have foreshadowed this possibility. In *Newman*, the government alleged that a number of securities analysts at various hedge funds and investment firms obtained material, nonpublic information from employees of public technology companies, and then passed this information along to portfolio managers at their firms. The government alleged that a Dell employee named Rob Ray gave confidential earnings information to an analyst (Goyal) he went to school with and with whom he had worked before. Goyal then passed along the Dell information to an analyst at Diamondback Capital Management, who told Newman, who was a Diamondback portfolio manager. Through a similar chain of sources, Chiasson, a portfolio manager at Level Global Investors, learned the same information. Through the same chain of information, both Newman and Chiasson learned about inside information regarding NVIDIA. Newman and Chiasson allegedly earned $4 million and $68 million, respectively, for their firms trading on that information. In each instance, Newman and Chiasson were three or four steps removed from the corporate insider who originally divulged the inside information. Neither Ray, nor the NVIDIA insider (Choi), were charged in any way, civilly or criminally with insider trading or other wrongdoing. However, in 2012, Newman and Chiasson were charged with multiple counts of criminal securities fraud in violation of Sections 10(b) and 32 of the Exchange Act of 1934 and Rule 10b-5. Following a jury trial, Newman and Chiasson were convicted and later sentenced to 54 and 78 months imprisonment respectively and ordered to pay $1.7 million and$6.3 million in fines and forfeitures, respectively. On appeal, Newman and Chiasson argued two dispositive issues: (1) they claimed that there was insufficient evidence that Ray and Choi, the original insiders, obtained any "personal benefit" in return

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for their breaches of duty toward their employers; and (2) they claimed that, to be convicted as remote tippees, the government must have proven that Newman and Chiasson knew that Ray and Choi received a personal benefit for their breaches of duty. They also claimed that the court failed to adequately instruct the jury that it was obligated to find both personal benefit to the tippers and the tippee's knowledge of that benefit. In its decision, the Second Circuit reviewed the foundations of insider trading liability. Under the "classical" theory, a corporate insider violates Section 10(b) and Rule 10b-5 by trading on her corporation's material, non-public, insider information. In doing so, the corporate insider breaches her fiduciary duty to the corporation. The alternative, but overlapping, "misappropriation" theory extends also to certain outsiders who, while they may not owe a fiduciary duty to the corporation, have obtained material non-public information about the corporation and "misappropriate" that information for their own personal gain while "pretending loyalty to the corporation." Beyond these two theories is "tippee" liability. If the corporate insider or misappropriator (the tipper) discloses material insider information to an outsider (the tippee) who then trades on that information, in some instances (but importantly, not all instances), the tippee too can be liable. According to the Second Circuit, the Supreme Court last delved into "tippee" liability back in 1983 in *Dirks v. SEC*. In *Dirks*, an analyst who received material inside information revealed that information to his clients who then traded on that information. The Supreme Court ultimately concluded that the analyst, Dirks, was not liable as a tippee because the tipper (the corporate insider) had not received any personal benefit in exchange for conveying the inside information to Dirks. The Supreme Court said that the test for whether the insider breached his fiduciary duty was whether "the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty." In doing so, the Supreme Court expressly rejected the theory that a tippee must refrain from trading "whenever he receives inside information from an insider." Instead, the tippee's duty to refrain from trading is "derivative from that of the insider's duty." In *Dirks*, the corporate insider provided inside information to the analyst to expose a corporate fraud, not to obtain a personal benefit; therefore, the insider had not breached a duty to the company's shareholders and so neither had Dirks, derivatively. The Second Circuit interpreted *Dirks* to mean that: (1) the tippee's liability derives only from the tipper's breach of a fiduciary duty, not just trading on material, inside information; (2) the corporate insider does not breach a fiduciary duty unless he receives a personal benefit in exchange for the disclosure; and (3) a tippee is liable only if he knows or should have known that the tipper exchanged insider information in exchange for a personal benefit. In so doing, the court interpreted *Dirks* to mean that "the insider's disclosure of confidential information, standing alone, is not a breach." According to the court, "nothing in the law requires a symmetry of information in the nation's securities markets." Based on its interpretation of *Dirks*, the Second Circuit concluded fairly easily not only that Newman and Chiasson's convictions had to be reversed, but that the case had to be thrown out altogether. The court concluded that the evidence was simply "too thin" to warrant any inference that the corporate insiders received any personal benefit in exchange for their tips. The court reiterated that personal benefit required either pecuniary gain or something akin to a substantial reputational benefit that would translate into a future monetary gain. Here, the "personal benefit" alleged was nothing more than advice given to a family friend or guidance on polishing a resume. If that was sufficient, the court reasoned, the personal benefit requirement would essentially mean nothing. So, the court concluded that the personal

benefit had to have “some consequence” and represent “at least a potential gain of a pecuniary or similarly valuable nature.” Under that standard, there had been no personal benefit provided to the corporate insider. Next, the court concluded that, regardless of the personal benefit conveyed, there was absolutely no evidence that Newman and Chiasson knew that they were trading on inside information and, particularly, that they knew that some personal benefit had been received by the corporate insider. The government’s assertion that they “must have known” did not pass muster because the evidence demonstrated that companies routinely disclosed information similar to the kind ultimately received by Newman and Chiasson as part of their investor relations practices, and the two defendants, being several steps removed from the corporations would not have known that this information came from different sources. So, because the court concluded that both the personal benefit to the corporate insider and knowledge of that personal benefit by the defendants were missing, Newman and Chiasson’s convictions had to be overturned and their indictments dismissed. *Newman* will undoubtedly have substantial ripple effects going forward. If it stands, it will most likely substantially diminish Mr. Bharara’s appetite for prosecutions of remote tippees. The Second Circuit noted the “doctrinal novelty” of the government’s targeting of “remote tippees many levels removed from corporate insiders” which the court contrasted with previous prosecutions generally involving tippees who participated directly in the tipper’s breach. Whether the ruling will stand is another matter. The U.S. Attorney’s Office has requested an additional thirty days in which to consider either a petition for rehearing or rehearing en banc; then, there is always the possibility that the government will seek Supreme Court review. While there is not a circuit split on this issue, particularly given the length of time since *Dirks*, the Supreme Court may consider this issue sufficiently important to the regulation of the securities markets to merit review. Meanwhile, Judge Andrew L. Carter, Jr., another district judge in the Southern District of New York, has already called into question at least four other insider trading guilty pleas related to IBM’s $1.2 billion acquisition of SPSS, Inc. And the SEC has already sought to drop its civil prosecution of Jordan Peixoto, who is accused of shorting Herbalife stock based on insider information about William Ackman’s short position against Herbalife. In that case, also, there were significant factual issues as to whether the alleged tippers actually received any personal benefit in exchange for providing inside information, and, if they did, whether Peixoto knew that. Particularly since the *Newman* analysis presumably applies civilly as well as criminally, this decision seems destined to reshape the boundaries of insider trading cases going forward.